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SIPDIS

STATE PASS USTR - WEISEL AND JENSEN
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USDOC FOR 4430/MAC/EAP/J.BAKER
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SUBJECT: Malaysia Promotes Islamic Finance: US Firms Concerned
over Governmental Preferences

REF A: Kuala Lumpur 1106
REF B: Kuala Lumpur 1317
REF C: Kuala Lumpur 1404

¶1. (U) Summary: Demand for Islamic financial paper continues to outstrip supply, due in large part to the growing interest of Middle East petrodollar holders to park their money in Sharia compliant instruments. The biggest success story to date is the Islamic bond (sukuk), the only product Islamic scholars from different parts of the globe have reached consensus on regarding their permissibility under Islamic law. The Government of Malaysia (GOM) continues to push for global consensus on a wider range of Islamic products and it is implementing regulatory and tax preferences for firms offering such products in an effort to make Malaysia a global hub for the industry in this growing niche market. As part of the GOM promotion effort, Malaysian Central Bank Governor Dr. Zeti Aziz has agreed to be the keynote speaker (see para 7) at a conference on Islamic Finance organized by the American-Malaysian Chamber of Commerce in Washington this October. Private sector views on the potential for Islamic finance are mixed but some U.S. firms have expressed concern that the GOM's preferential policies are creating an uneven playing field in Malaysia's financial market. End summary.

Lack of Consensus on Sharia Compliance
is a Major Constraint

¶2. (U) A primary constraint in developing the Islamic finance industry is the lack of consensus among Islamic scholars from the Middle East and Southeast Asia on what is permissible under Sharia (Islamic law). Two fundamental differences account for the main barriers between how Islamic finance is practiced in Malaysia vs. the Middle East: the selling of debt instruments and the mingling of conventional and Islamic funds.

¶3. (U) In Malaysia, Islamic scholars have accepted the practice of selling a debt instrument, while Middle Eastern scholars have determined that this is forbidden. In the Middle East, a bank practicing both conventional and Islamic finance conducts both types of business off the same balance sheet. In Malaysia a conventional bank engaging in Islamic finance is required to maintain a separate "window" with a separate set of books.

The Islamic Bond: No Secret about its Success

¶4. (U) The concept of an "Islamic bond," however, has been accepted as Sharia-compliant by Islamic Scholars in both Southeast Asia and the Middle East. In fact, it is the only Islamic financial product on which consensus has been reached. This consensus is widely credited for driving demand for it through the roof. For example, earlier this year Khazanah, a Malaysian government-owned investment corporation, decided to offer a US\$600 million equity-linked Islamic bond denominated in U.S. dollars. The bond was thirteen times oversubscribed; subsequently Khazanah decided to increase the amount on offer by 42% to US\$850 million (REF A), with fifty percent of the issuance allocated to investors from the Middle East.

Building Consensus on Other Islamic Principles

¶5. (U) Recognizing that consensus on Sharia compliance will be essential to developing this niche market, the GOM has established the Malaysian International Islamic Finance Center (MIFC) which includes a board of Islamic scholars from an array of different Muslim-majority countries. The GOM sponsors board meetings in Paris, London, and elsewhere in an effort to encourage consensus-building on Sharia compliant financial instruments. Central Bank Governor Dr. Zeti Akhtar Aziz told U.S. Ambassador Lafleur that she expected broad consensus among Southeast Asian and Middle Eastern Sharia scholars within two years (REF B). Consistent with the GOM's effort to promote Islamic finance, Central Bank Governor Dr. Zeti has agreed to deliver the keynote address at a conference in Washington, D.C. on October 18 entitled "Islamic Finance in Southeast Asia: Local Practice, Global Impact."

Malaysia's Federal Budget Delivers

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More Favors for Islamic Finance

¶6. (U) The GOM is also using its Federal Budget Proposal for 2008, released September 7, to introduce provisions designed to promote Malaysia as a hub for Islamic Finance. These include:

-- Non-resident experts in Islamic finance will be exempt from income tax, subject to verification of their credentials by the Malaysian International Islamic Financial Center (MIFC). This is designed to attract more talent from countries in the Middle East, many of which do not impose income tax. (This provision was championed by Citibank Malaysia which engages in both conventional and Islamic finance.)

-- An existing tax exemption for management fees for Islamic funds for foreign investors will be extended to Islamic funds managed for local investors as well.

-- Tax exemptions for issuers of Islamic Financing through Special Purpose Vehicles will be expanded.

-- Specific tax provisions for Islamic insurance (takaful) operators will be introduced.

Players Get Energized

¶7. (U) With such strong GOM encouragement, interest in Islamic finance is accelerating in Malaysia. On September 17 Bank Islam Malaysia signed a strategic partnership with London-based European Islamic Investment Bank PLC, according to press reports. The partnership is intended to link up the European and Asian markets for financial products that are compliant with the principles of Sharia (Islamic law). Bank Islam Managing Director Zukri Samat told reporters the bank planned to bid on arranging several Islamic bond issues, including one for US\$300 million jointly with its new partner.

Conventional Finance Being Crowded Out?

¶8. (SBU) Brad Bennett, CEO of American Home Assurance Company Malaysia, a wholly-owned subsidiary of U.S.-based American Insurance Group, told ECONOFF he was concerned that preferential regulatory treatment of Islamic Insurance (takaful) was crowding out conventional insurance products in Malaysia. The company had applied for a license to do Islamic insurance in Malaysia, but has yet to receive approval. Meanwhile, customers are switching, he said. On August 29, Central Bank Deputy Governor Zamani Abdul Ghani invited applications for reinsurance licenses (REF C).

¶9. (SBU) Citigroup Malaysia CEO Sanjeev Nanavati expressed similar concerns, saying the GOM's special concessions and incentives for Islamic finance gave its practitioners an unfair advantage. But Citi continues to believe Islamic finance faces so many obstacles that it will continue to struggle, even with GOM support.

¶10. (U) Comment: The Government of Malaysia is determined to make the country a global hub for the industry and thereby maintain the leading edge its financial firms currently possess in this growing niche. Moreover, it is coming through with the funding, the political pressure, and the regulatory and tax advantages to smooth development for financial companies in this highly regulated economy. Obstacles and opportunities in this niche market will be reviewed septel.